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PRESCRIPTIVE APPROACH OVERLOOKED BY MEDIA

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INTRODUCTION/SUMMARY

1. (SBU) Media coverage of the International Monetary Fund's (IMF) May 2 unveiling in Hong Kong of its Asia-Pacific regional outlook is based primarily on an advance press release and does not capture the prescriptive approach put forward at the event with regard to China's currency and macroeconomic policies. The IMF used the event to call on China to (a) exercise greater currency flexibility and (b) to increase spending on education, health care, and retirement as a way to reduce the need for "precautionary savings." END
INTRODUCTION/SUMMARY

PRESENTATION IN HONG KONG

2. (SBU) On May 2 in Hong Kong, the IMF Deputy Director for Asia, Wanda Tseng, presented the latest Regional Economic Outlook (REO) for the Asia-Pacific region. A full copy of the REO is available on www.imf.org. The purpose of this message is not to summarize the full report but to highlight a number of China- and Hong Kong-related comments made at the event that are likely to be of interest to analysts and policy makers.

CALL FOR RMB FLEXIBILITY

3. (U) Tseng observed that despite the introduction of a new currency regime in July 2005, the renminbi (RMB) has only risen 1.25 percent since the initial 2.1 percent revaluation. Though unwilling to provide a target for the RMB's value when asked, Tseng noted several times that China is not using the full flexibility available to it under the new RMB value-setting system. There is a high cost and a loss of policy flexibility associated with China's policy of partially sterilizing excess foreign exchange inflows. One negative result of this approach is the introduction of excess liquidity into the mainland economy, which in turn is fueling a resurgence of loans and investment that needs to be reined in.

EMPHASIS ON CHINA AND U.S. IN EFFECTING ORDERLY ADJUSTMENTS

14. (U) Tseng made repeated reference to the U.S. current account deficit along with China's accumulation of foreign exchange reserves. She suggested a role for both the U.S. and China in managing global financial imbalances. At this point, there is no apparent problem in managing the situation, but there is likely medium-term risk considering that there is a limit to how much of the U.S. current account deficit foreigners are willing finance. When asked whether the U.S. or Asia had a more important role to play in working out imbalances, Tseng responded by referring exclusively to the U.S., which she said must act "urgently"; a rise in U.S. savings will be key. With regard to China's foreign exchange reserves, Tseng would not name a figure that could be deemed "adequate," but stated that China has "no need to go further" in its accumulation.

REBALANCING CHINA'S ECONOMY

15. (U) The REO report suggests "a very stark picture" emerging from the fact that household consumption in China only accounted for approximately 40 percent of GDP last year.

Although such consumption has grown at an average annual rate of 8 percent since the early 1990's, this lags GDP expansion. Savings now make up approximately 30 percent of GDP. One factor in the high savings rate is "precautionary savings motives," resulting in part from the decreasing role of state-owned enterprises in the provision of pensions, health care, and schooling -- and much of this responsibility has now been transferred to central and local governments that face budget crunches.

16. (U) Consequently, education spending is now only about 2.25 percent of GDP, the lowest among Asian economies, while

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the proportion given to health care is 0.5 percent of GDP. Making up for low expenditures in these two areas consumes an increasing proportion of household consumption. Uncertainty about such expenses in the future as well as anxieties about funding old-age support -- which, in part, derives from the effects of the one-child policy -- underpins the need for precautionary savings. Tseng suggested that China reduce the uncertainty facing households (and therefore promote their propensity to consume) by boosting government spending on education, health care and pensions. The need to save can also be reduced through banking reform, which improves access to credit, reducing the need to accumulate funds to finance major purchases or small family businesses. Household consumption might also be boosted through exchange rate flexibility if RMB appreciation raises purchasing power.

HONG KONG STANDS TO GAIN

17. (U) Tseng, joined by IMF Resident Representative Paul Gruenwald, said that the demand from the mainland for Hong Kong business services remains high. This is a huge advantage for the city in the context of public anxiety expressed here about the potential for "marginalization." Recent steps to allow mainlanders to invest individually in offshore financial instruments are welcome, but the impact on Hong Kong is likely to be small in the near term. The peg of the Hong Kong dollar to the U.S. dollar has worked well, but its continuation is a local choice. The IMF forecasts that Hong Kong's GDP will likely expand 5-5.5 percent this year, down from 7.3 percent in 2006.
Cunningham